

Economic Outlook

The national and California economies slowed in 2001, burdened by declining capital spending, a cooling stock market, struggling foreign economies, and the September 11 terrorist attacks. The national economy slipped into recession in March, closing the books on the record-long economic expansion. Federal Reserve interest rate cuts, tax cuts, and increased military spending have kept the recession mild. With additional doses of fiscal and monetary policy in 2002, the national economy should begin to recover by midyear.

California fared better than most of the nation. For example, percentage job growth was much higher in the state than in the nation. Still, only about half as many new jobs were created in 2001 as in 2000. As a result, unemployment ended the year higher than it began. Like the national economy, the state economy should begin to rebound by midyear.

California fell short of the nation by one measure in 2001—personal income growth. However, it was the stock market rather than the slowing economy that was responsible. In less than a decade, California personal income and, in turn, state tax revenues have become much more sensitive to swings in the stock market.

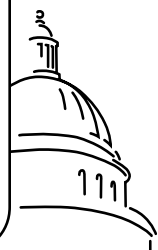
The Nation—All Good Things Come to an End

The national economic expansion had already slowed considerably as it entered 2001. Hopes that economic growth would settle into a more moderate, but sustainable pace were dashed as the economy decelerated throughout the year. Output grew only slightly in the second quarter, fell modestly in the third quarter, and appears to have fallen

more sharply in the fourth quarter. So far, the recession has been mild relative to national recessions in the 1970s and 1980s.

A number of developments combined to end the long expansion. Capital investment plunged in the second quarter of 2001 when businesses discovered that they had more than enough new equipment and software after investing heavily leading up to Y2K. Also, many dot-coms, intense users of high-tech equipment and software, had failed as investors soured on them. As demand for high-tech equipment and software fell, the profits of equipment manufacturers and software producers plummeted along with their (in many cases) inflated share prices. Contagion pushed down the share prices of other high-tech companies, and soon the NASDAQ bubble was burst. At the same time, major foreign markets for American goods were slowing, in step with the U.S. economy. Struggling economies, declining equity prices, and deteriorating labor markets took a toll on consumer confidence. The September 11 attacks accelerated the economy's decline and may well have sealed the fate of the expansion.

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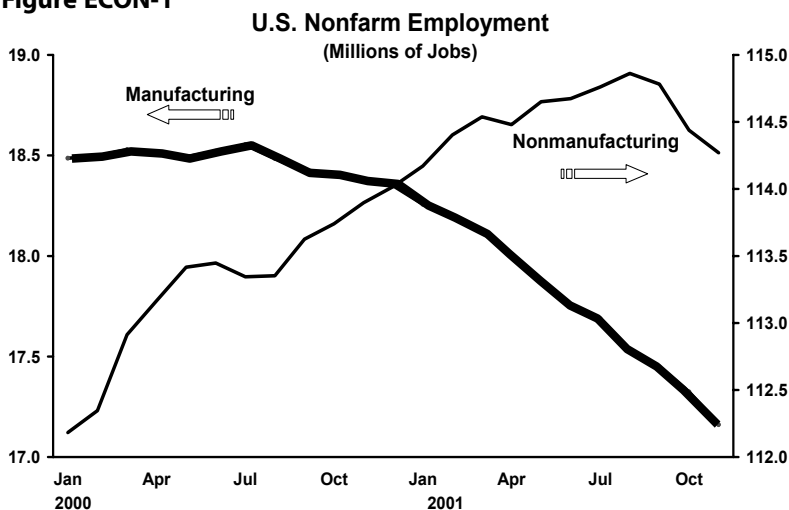
The recession's toll on the labor market is clear. Unemployment began 2001 at 4.2 percent; by November, it was up to 5.7 percent. New claims for unemployment insurance benefits trended upward during the first eight months of the year, and jumped to over 500,000 after the September 11 attacks before falling back somewhat as year-end

Unlike the early-1990s recession, which was sometimes referred to as the "English-speaking recession," most of the other major world economies are sharing in the misery this time. In the third quarter of 2001, the economy contracted in Japan, Germany, and Canada and expanded only modestly in the United Kingdom, France, and Italy. Thus, the United States cannot count on much help from abroad as it tries to recover. Any increase in domestic demand is likely to contribute to a larger trade deficit and lower domestic output growth than would be the case if other economies were growing.

On the positive side, consumers continued to spend despite steep losses in household stock market wealth and the attacks of September 11. Enticed by factory incentives, consumers pushed light vehicle sales to a record level of more than 21 million units at an annual rate in October, followed by a robust rate of 18 million units in November. Personal consumption expenditures reached record levels in October in part because of the strong auto sales (Figure ECON-2). In the face of a deteriorating economy, consumers have not pulled back as much as in earlier recessions.

The Federal Reserve was no less persistent, cutting short-term interest rates 11 times in 2001, trying to keep the expansion alive. In all, the central bank lowered the federal funds rate from 6.5 percent at the beginning of the year to 1.75 percent in December. The full economic impact of the cuts will not appear until the middle of 2002. (It can

Figure ECON-1



neared. Manufacturing employment continued a decline that began in July 2000, with job losses totaling about 1.4 million. Non-manufacturing employment, on the other hand, continued to grow until August 2001 before dropping about 600,000 (Figure ECON-1). While the recession remained concentrated in manufacturing, it had clearly spread to other industries by year end.



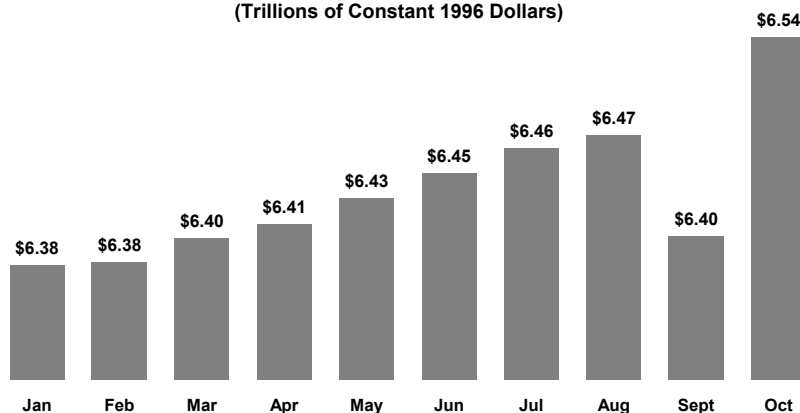
take time for a change in monetary policy to influence the economy because consumers and businesses have to evaluate how the changed financial environment affects them.)

Tax cuts and spending increases also stimulated the economy in 2001, and more are planned for 2002. The IRS mailed approximately \$40 billion in tax rebates to households during the third quarter, providing a timely boost to consumers. Congress approved emergency spending of \$40 billion for recovery efforts, national security, and assistance to airlines in the wake of the September 11 attacks. The House of Representatives approved a three-year \$218 billion economic stimulus package at year end, but the Senate adjourned without taking a vote on it. This package included a cut in marginal tax rates for households, accelerated depreciation for business, and increased assistance to unemployed workers. Congress could reconsider the package when it reconvenes in January if economic conditions have deteriorated. Separate from the stimulus plan is a \$42 billion increase in military spending—the biggest increase in two decades.

Declining oil and gasoline prices boosted consumer purchasing power near the end of 2001. Much like a tax cut, lower energy prices allow households and businesses to increase their purchases of other goods and services.

Figure ECON-2

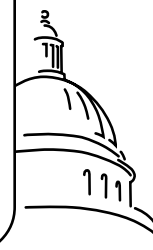
2001 Real Personal Consumption Expenditures
(Trillions of Constant 1996 Dollars)



As the expansionary effects of monetary and fiscal policy and lower energy prices work their way through the economy, and businesses continue to trim undesired inventory, the downturn should slow. Barring another confidence-shattering event, some of the jobs lost in businesses directly affected by the September 11 attacks—airlines, restaurants, and lodging—should be restored as consumers regain confidence in public safety.

The main risks to the outlook are consumers losing confidence before the economy begins to turn around and a protraction of the high-tech recession. If consumers lose faith, the recession will be deeper and longer. An extended high-tech recession might not delay the recovery, but it would take some steam out of it.

Barring these risks, the downturn should end by midyear 2002. The recovery may be tepid at first, particularly if capital spending is late in



rebounding. However, by the fourth quarter of 2002, economic growth should be quite strong. Unemployment will continue to rise after the economy has begun to recover, especially if the recovery is slow initially. Employers usually wait to expand payrolls until they are quite certain that a recovery is under way. The national forecast is summarized in Figure ECON-7 at the end of this section.

California— A Challenging Year Ahead

California's economy slowed in 2001, but fared better than most other state economies. Job growth slipped to 1.8 percent in the state while falling to 0.3 percent in the nation (Figure ECON-3). Cutbacks by manufacturers of electronic components, builders, firms providing computer programming and related services, and companies providing personnel supply services, along with slower job growth in retailing, accounted for over half of the drop in job growth in the state. Steady gains in local education moderated the decline in overall jobs. State unemployment rose from 4.6 percent in January 2001 to 6.0 percent in November, a smaller jump than in the nation.

The State's job losses were concentrated in the San Francisco Bay Area, home to most of the state's dot-coms and high-tech firms. Unemployment in

Figure ECON-3

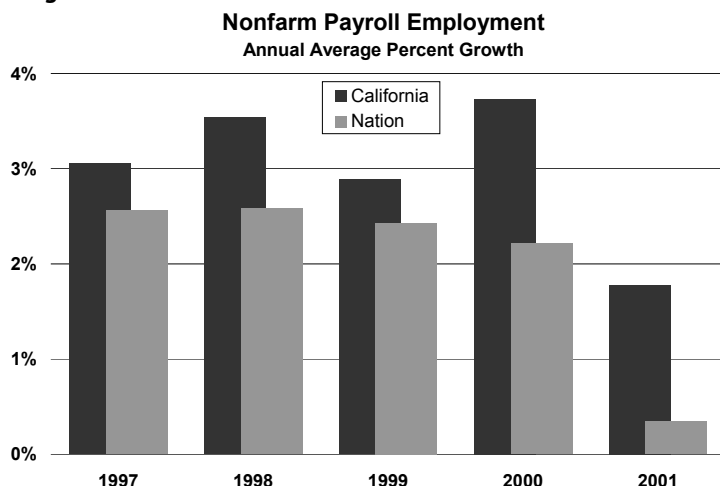
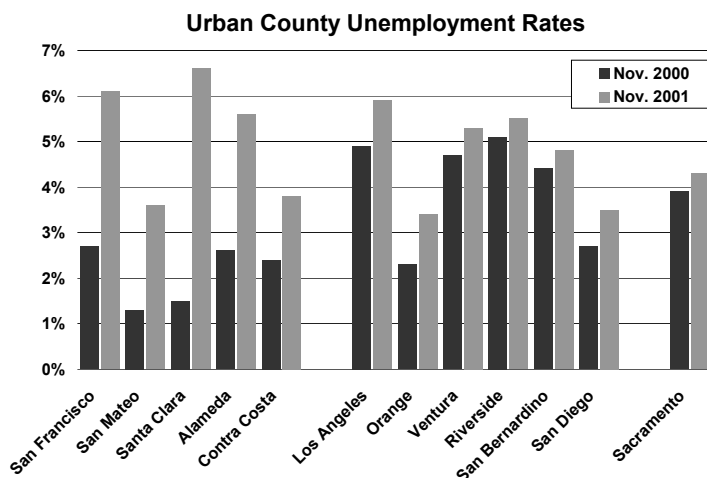


Figure ECON-4



Santa Clara County jumped from 1.5 percent in November 2000 to 6.6 in November 2001. The increase in San Francisco County was also large: 2.7 percent to 6.1 percent. Unemployment also rose in Southern California and Sacramento County but much more moderately (Figure ECON-4).

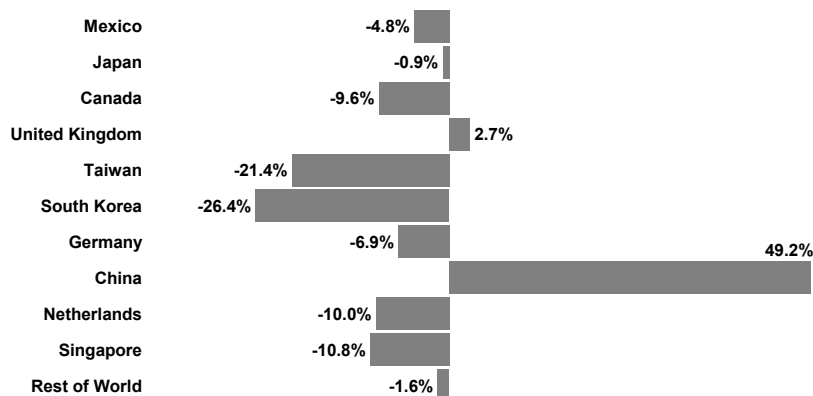
Exports of California-made merchandise fell in the first three quarters of 2001 as the economies of many of the state's major trading partners slowed. The Canadian, Mexican, Japanese, German, Taiwanese, and Dutch economies contracted in the third quarter of 2001, for example. All except Japan were growing a year earlier—Canada, Mexico, and Taiwan very quickly. Only China continued to grow strongly as a major market for California exports (Figure ECON-5).

The September 11 terrorist attacks dealt a severe blow to California tourism. Airlines, restaurants, lodging, and shopping have been most adversely affected. Big-city markets, which rely more on out-of-state and foreign visitors, have fared worse than suburban and rural tourism. The industry bounced back somewhat by the end of the year but was still operating below year-ago levels.

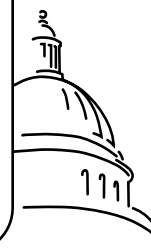
Construction slowed in the state during 2001. Permits issued for new housing units in the first 11 months were slightly below the year-ago level, and the dollar valuation of private nonresidential building permitted was down almost 9 percent. Industrial permits were sharply lower.

Figure ECON-5

Growth in Exports to Top California Markets
First Three Quarters: 2001 Compared with 2000



As in the rest of the nation, monetary and fiscal policy, lower energy prices, and earlier inventory paring will buoy the California economy in the first half of 2002. Improved confidence in public safety should boost the state's tourism industry. As with the rest of the nation, the main risks to the outlook are a sharp retrenchment by consumers and a deepening and extension of the high-tech recession. With its significant high-tech sector, California is more at risk to the latter than the nation. Barring these problems, a rebound should start about midyear. On an annual average basis, job growth is forecast at 0.3 percent, although gains on a year-end 2001-02 basis may be closer to 1 percent. The California forecast is summarized in Figure ECON-7 at the end of this section.

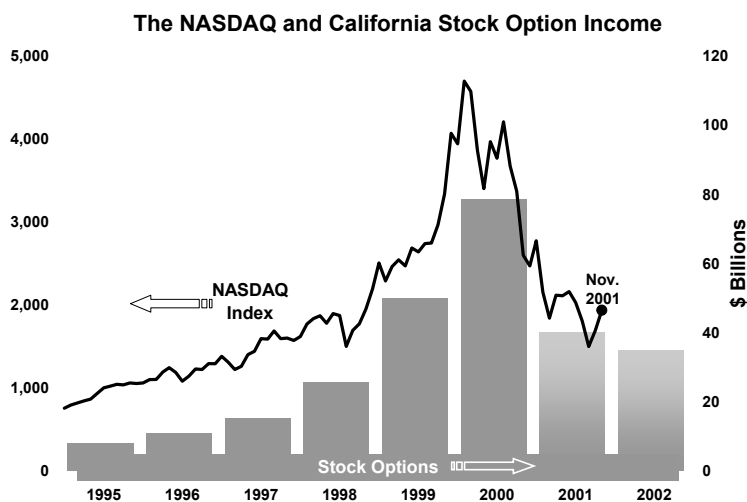


CALIFORNIA INCOME AND THE STOCK MARKET

After growing almost 10 percent in 2000, California personal income advanced only 1.4 percent in 2001. This was a much sharper swing than

The big increase in bonuses and stock option income in 2000 was the last of a five-year string of strong gains. Bonuses and stock option income grew from \$8 billion, or 2 percent of total wages and salary income, in 1995 to \$79 billion, or 12 percent of total wage and salary income, in 2000 (Figure ECON-6).

Figure ECON-6



Two developments fueled this fast growth: soaring stock prices and the rapid adoption by companies—especially high-tech companies and dot-coms—of stock options as part of employee compensation. Employees like stock options because of the possibility that the options could become very valuable if the company is successful or is judged by stock analysts to have great potential. Companies like stock options because they motivate employees to work extremely hard, tie employees to the company for a number of years until their options become exercisable, and improve profitability in the short run by reducing the need for cash wage payments.

occurred in job growth. More than a slowing economy was at work: bonuses and stock option income, which are part of total wage and salary income and, thus, personal income, fell sharply in 2001 after growing very strongly in 2000. (Realized capital gains on stocks also fell sharply and cut into State tax revenues. Capital gains, however, are not part of income in the official economic statistics and, thus, are not considered here. For a discussion of the effects of falling capital gains on tax revenues, see the Revenue Estimates section.)

In fact, some employees did reap handsome gains as high-tech and dot-com stocks soared in value in the second half of the 1990s. The tech-heavy NASDAQ Composite stock index appreciated over 900 percent. But stock prices peaked in early 2000, and the plunge that followed wiped out much of the prior two years' gains. The tech and dot-com stocks were hit particularly hard; the NASDAQ lost nearly 70 percent of its value between February 2000 and September 2001. Many employee stock options became



worthless, especially recently awarded ones, and estimated stock option income fell to \$41 billion in 2001.

The rapid rise in bonuses and stock option income between 1995 and 2000 and their collapse in 2001 account for much of the volatility in total wages and salaries during this time. In 1998, the increase in bonuses and stock option income accounted for 25 percent of the increase in total wages and salaries; in 1999, it was 51 percent; and in 2000, 39 percent. Even more eye-opening, the decline of bonus and option income in 2001 more than offset the increase in wage and salary income from all other sources.

It is unlikely that bonus and stock option income will create so much volatility in both total personal income and state tax revenues in the coming years. The bubble in tech and dot-com stocks was a critical ingredient in the recent experience, and for one bubble to be closely followed by another is unlikely. It should be clear now that it is possible for tech companies and dot-coms to lose money and even fail. A more rational assessment of the prospects of tech companies and dot-coms is likely going forward.

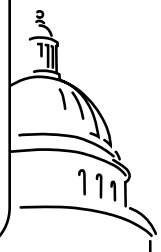


Figure ECON-7

Selected Economic Data for 2001, 2002, and 2003

		Forecast	
United States	2001	2002	2003
Real gross domestic product (1996 dollar, percent change)	1.1	0.5	4.4
Personal consumption expenditures	2.8	1.2	4.0
Gross private domestic investment	-7.3	-2.5	7.3
Government purchases of goods and services	3.4	3.0	2.0
GDP deflator (1996=100, percent change)	2.3	1.6	2.0
GDP (current dollar, percent change)	3.4	2.1	6.6
Federal funds rate (percent)	3.93	2.41	4.53
Personal income (percent change)	5.0	2.6	5.6
Corporate profits before taxes (percent change)	-16.4	-3.5	14.3
Nonfarm wage and salary employment (millions)	132.2	131.5	132.9
(percent change)	0.3	-0.5	1.1
Unemployment rate (percent)	4.8	6.2	5.7
Housing starts (millions)	1.59	1.57	1.51
(percent change)	0.9	-1.1	-3.8
New car sales (millions)	8.3	7.3	8.0
(percent change)	-6.0	-12.3	9.0
Consumer price index (1982-84=100)	177.2	180.5	184.4
(percent change)	2.9	1.8	2.2
California			
Civilian labor force (thousands)	17,363	17,500	17,828
(percent change)	1.6	0.8	1.9
Civilian employment (thousands)	16,463	16,410	16,770
(percent change)	1.3	-0.3	2.2
Unemployment (thousands)	900	1,089	1,058
(percent change)	6.7	21.1	-2.9
Unemployment rate (percent)	5.2	6.2	5.9
Nonfarm wage and salary employment (thousands)	14,770	14,812	15,168
(percent change)	1.8	0.3	2.4
Personal income (billions)	\$1,110.3	\$1,139.3	\$1,224.7
(percent change)	1.4	2.6	7.5
Housing units authorized (thousands)	142	145	149
(percent change)	-5.0	2.4	2.6
Corporate profits before taxes (billions)	\$89.5	\$88.6	\$97.6
(percent change)	-9.9	-1.0	10.1
New auto registrations (thousands)	1,762	1,614	1,628
(percent change)	0.7	-8.4	0.9
Total taxable sales (billions)	\$432.8	\$436.4	\$469.1
(percent change)	-2.0	0.8	7.5
Consumer price index (1982-84=100)	182.0	185.1	188.5
(percent change)	4.1	1.7	1.8

Note: Percentage changes calculated from unrounded data.

